1994 Annual Report

Montana State Compensation Insurance Fund
5 South Last Chance Gulch, Helena, Montana 59601

Building the Foundation

Table of Contents

Mission Statement

The State Fund will provide to all employers an available market for workers' compensation and occupational disease coverage. Inherent in this is the responsibility for achievement of extraordinary service to our customers and superior execution in everything we do. Service will be provided at the lowest possible cost while paying the statutorily established benefits. We will achieve financial solvency and stability for our stakeholders and develop a partnership in a true spirit of cooperation. Success depends upon a customer-focused, team-oriented, high performance culture that is rewarding and challenging for our employees. We will become an industry leader in developing and leveraging our organization's services and functions.

Letter from the Chairman of the Board and the President/CEO

The State Fund is a different organization today from what it was just a year ago. Management has taken a series of actions aimed at rebuilding our foundation and strengthening it from the ground level. Fiscal year 1993-94 was indeed a year of significant change for the State Fund. This change process did not come easily, as it required us to focus on our strengths and weaknesses. It then challenged us to identify our critical issues and to develop action plans to meet these issues head on, with new and innovative ways of doing business.

Rick Hill
Chairman

As you read through this annual report, we hope you too will come away with a sense of the culture change underway and an awareness of the new foundation that was built. These changes were just the first steps to running the State Fund more like a private insurance company operation, therefore, enabling us to provide our customers with the superior service levels they deserve, at the lowest possible cost.

Specifically, the most critical element of our foundation rebuilding included action plans, with accountability for results, to address: financial stability, customer focus, cost containment, human resources and operational transformation. These issues were addressed in a strategic business planning process involving a cross-section of key staff . The State Fund Strategic Plan forms the base from which we have launched a new era for the State Fund.

For fiscal year ending June 30, 1994 the State Fund's deficit of $25,629;000 was eliminated and assets now exceed the discounted liabilities by $6,225,000. The $31,854,000 positive result of operations is primarily due to past legislative actions, improving loss experience, improved rate level adequacy and internal operational improvements. During the same period of time, the Old Fund's deficit reduced from $497,436,000 (FY 1993-94) to $471,393,000. The 3,134 claims remaining in the Old Fund at the end of fiscal year 94 are now receiving renewed aggressive claim management attention. With a newly developed claim strategy and action plan, a dedicated unit is focusing solely on managing these Old Fund claims. Management is anticipating this strategy

Carl Swanson
President/CEO

will yield significant improvements.

As a result of legislation passed in 1993, the State Fund now has a strong fraud fighting capability. Recoveries and savings realized this past year in future claim costs due to fraud investigations totalled $1,365,852 and another $341,526 receivable in under-reported premium and court ordered restitution . We are in the process of integrating key fraud indicators, automatic alerts, referral and investigation procedures into our new Benefit Information System technology currently under development. This will provide our customers with further enhanced State Fund fraud detection capability.

To address the subjective nature of reserving, the State Fund contracted to install the Micro Insurance Reserve Analysis (MIRA) System, which should be implemented during the third quarter of FY 1994-95. This system will allow the Fund to calculate, on an objective basis, more consistent dollar estimates for medical and indemnity reserves, as well as estimate duration for a claim. The past issue of inadequate case reserving should be eliminated with implementation of this state-of-the-art system.

The automated Benefit Information System Project (BIS) is well underway and the external design phase has been completed. The purpose of BIS is to provide a computerized application system integrating image, text, and data processing, which will enable the State Fund Claim Department to process claims quickly, efficiently , and reliably. The project started with a re-engineering of work flows to eliminate inefficiencies and redundancies in our processes. This state-of-the-art system will be operational during the first quarter of FY 1995-96.

In addition to our systems capability, the ultimate success and relative service competitiveness of the State Fund will be determined by the quality of our people, their ability to contribute, and their commitment to our mission. Significant work has been focused on our critical human resources. There is now a stronger top management team in place augmented by new leadership in Administration and Finance, Claim, Loss Control and Premium Audit, Policyholders Service, Special Projects, Internal Audit, Human Resources, and Industry and Consumer Affairs. Reorganization to strengthen the State Fund in critical areas and to compress managerial layers, bringing management closer to the action, has occurred.

A Design Team comprised of some of our very best employees with support and guidance from external consultants, is now developing a competency based, results oriented, pay-for-performance human resources management program. Another critical step in our rebuilding process is our skill development. We have staffed a training function within the State Fund and will be completing an employee self-assessment of core skills in the near future. This will be followed by an aggressive schedule of training focused on management and supervision, insurance skills, communications and technology/systems.

Furthermore, Best Practices disciplines have been developed in our claims administration and are currently being implemented. This discipline is being developed in other areas of the State Fund operations, such as loss control, premium audit, and policyholders service. We anticipate the largest near term impact to come from improved claim administration, loss control and premium audit. Enhanced policyholders ser-

vice and underwriting will take time to fully implement, but our re-engineering project will begin within a few months. This will have a profound impact over the long term.

The State Fund is now moving toward implementing specialized products to meet our customer needs. This will include a new differentiated pricing strategy providing advantages to many of our customers and the State Fund. It will match premium rates more closely to the risk exposure. Good loss experience and safety program support by top management, supported by our enhanced loss control and cost containment programs, will allow preferred pricing to appropriate customers.

Developing a strong Managed Care Organization (MCO) has been the focus of intense work during this past year. We expect to start contracting with our first MCO in December, 1994 and with others soon thereafter. In addition to higher quality care for the injured worker, our customers will benefit from the cost containment savings expected through earlier return to work focus. Preferred Provider Organizations are already established.

The Closed Claim Study, which has been completed, reinforced our recognition that lag times in many areas are simply unacceptable and cause cost increase to the system. The Strategic Business Plan focused on many of these areas and coupled with system improvements, such as the BIS, we expect significant improvements to be realized. One area, reporting of injuries to us by our customers, has already shown noticeable improvement through implementation in July of an 800 injury reporting phone number. The average reporting time has reduced from 27 to 19 days after just four months in operation. Although significantly greater reductions are needed to fully realize potential cost savings for our customers, these results are encouraging.

In summary, the State Fund is a much more focused and customer oriented organization today than a year ago. We are committed to our mission of providing extraordinary service to our customers at the lowest possible cost. We clearly have a long way to go, but progress is being made. With your continued support, we are more confident than ever that a superior Montana workers' compensation system will evolve.

Rick Hill
Chairman of the Board

Carl Swanson
President/CEO

The Cornerstones of Value Added Customer Service

Cornerstones provide strength to any foundation; thus, value added customer services provide the cornerstones of stability to the State Fund. Services being emphasized in our daily business operations include:

- **Quality attention to customer and beneficiary needs;**
- **Accessibility;**
- **Responsiveness; and**
- **Education and training.**

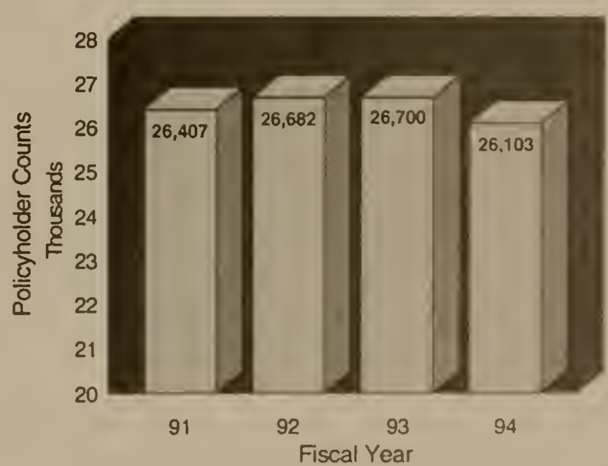
The State Fund held a "Customer Service" week to provide employees knowledge of the highest standards of service and of customer expectations. The State Fund also initiated a variety of new programs aimed at improving accessibility, responsiveness, and appreciation to customers.

An Early Reporting Unit was created in fiscal year 1993-94 to improve accessibility. This unit allows customers to report claims immediately by FAX or by telephone 1-800-332-6102. This ultimately reduces reporting time and allows our claim adjustors to make earlier contact with the injured worker.

The State Fund is initiating special programs to assign loss control, customer service representatives, and claims adjustors to specific customer accounts. This provides consistency in service and more industry-specific support to key customers.

Forming partnerships with customers is an important component of the State Fund's success. One program includes aggressive

Number of Policyholders



loss control consultation with policyholders. A top priority for this program is to inform and advise customers of the requirements of the Safety Culture Act. This program is designed to reduce the incidence and severity of occupational injury and illness by promoting safety in the workplace.

The State Fund provided 96 safety education and training sessions to 1,737 customers throughout fiscal year 1993-94. In addition, the Loss Control staff provided consulting services regarding job hazards and safety at 2,401 policyholder locations.

Another goal is improving daily policyholder services and communications. Policy Services Division provided information and service to over 26,000 customers. This goal was assisted by our Missoula-based customer service office.

In the spirit of developing a solid partnership with the medical community, the State Fund conducted meetings throughout the state informing providers and encouraging communication on payment issues. On-site tours of the State Fund bill paying processes were hosted for providers. Developing preferred provider organizations improved availability and the quality of services. This will provide a framework for significant cost savings. Direct value added services to beneficiaries include improved attention to injured workers' needs through implementation of:

- **improved claims investigations and new claims processing;**
- **emphasis on early return-to-work programs;**
- **proactive communications;**
- **streamlined claims processes; and**
- **improved rehabilitation referral and follow-up.**

Number of Policyholder Employees Insured by the State Fund

(Established based on reported payroll and State of Montana average weekly wage.)

Progress in customer service is of paramount importance to the State Fund. Our customers can expect significant improvements as the State Fund implements electronic access, provides on-site customer service visits to new policyholders, and continues to make changes based on surveys of customers' needs and expectations.

Strength through Financial Stability

The State Fund has made a firm commitment to building organizational strength through financial stability. Management recognizes this strength as a necessary element for securing the future of the fund for our customers.

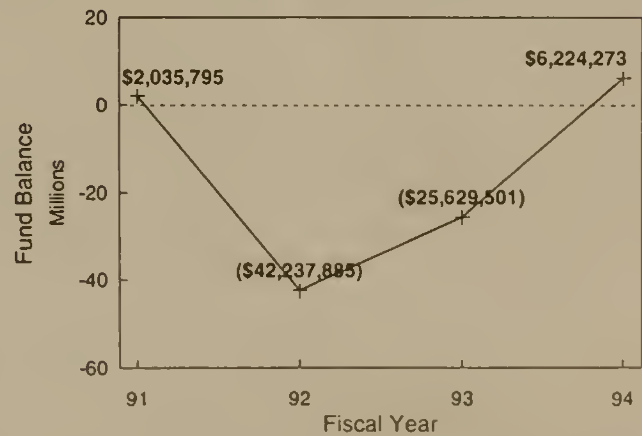
Achieving financial stability includes:

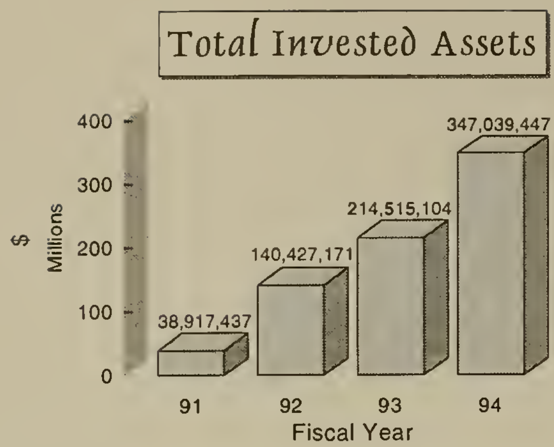
- **controlling claims costs;**
- **improving staff productivity and business operations;**
- **insuring adequate premium level; and**
- **managing administrative costs.**

Premium rate adequacy is a significant contributor to fund solvency. During fiscal year 1993-94, the State Fund achieved a level of rate adequacy sufficient to contribute to surplus and build toward mandated surpluses. In addition, the State Fund increased long-term invested assets and total invested assets.

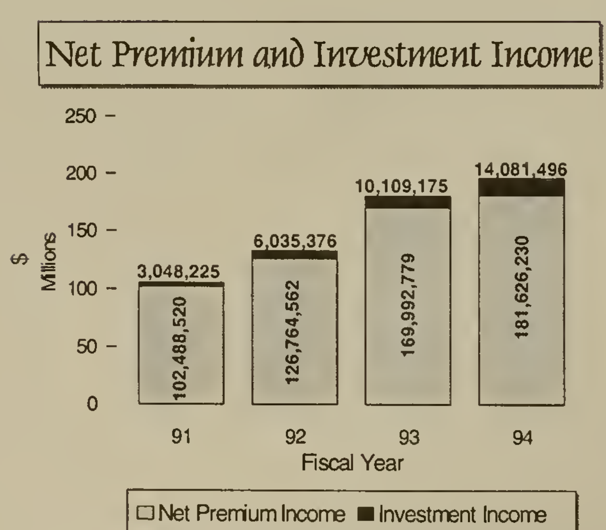
The State Fund completely redesigned its method of collecting premiums. This

Improving Fund Equity



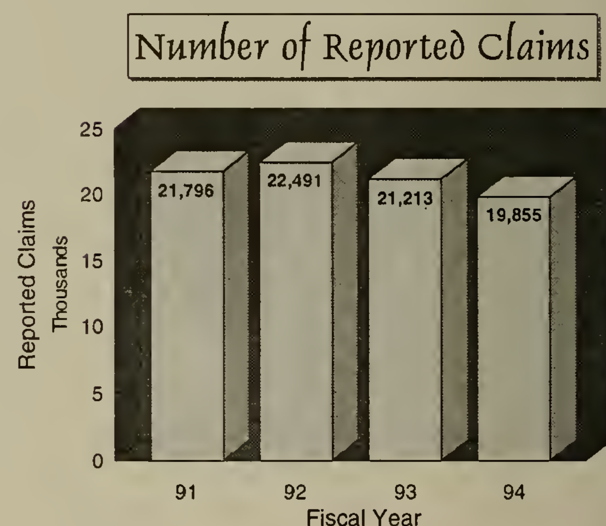


change, called the Premium in Advance project, enabled the State Fund to mirror the payment methods utilized by most private insurance carriers and to break away from outdated premium deposits and collection of premium in arrears. In addition to making significant business process improvements, and reducing up to a six-month credit risk, this project re-



sulted in an improvement of investment earnings. This should have a positive effect on future premium rates.

Improved product lines will provide multiple coverage options for current and prospective customers meeting certain underwriting criteria, such as good loss experience and established safety



programs. Designed to attract and retain a solid customer base, the State Fund policy options will include:

- **group discounts;**
- **retrospective rating plans;**
- **scheduled ratings; and**
- **deductible options.**

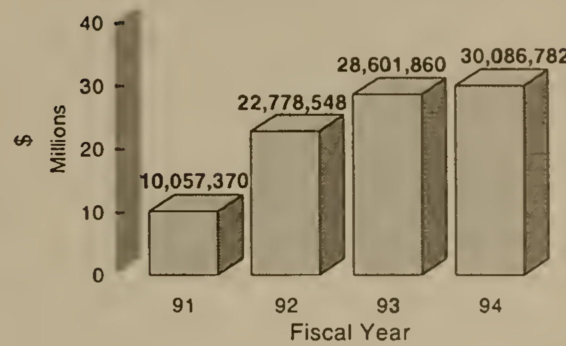
The Montana legislature provided a foundation for the State Fund to implement a

Number of Wage Loss Claims

variety of programs aimed at medical cost containment. Throughout fiscal year 1993-94, the State Fund worked hard to educate providers and to establish the foundation for both Managed Care Organizations and Preferred Provider Organizations. Through the use of managed care, the State Fund will be able to:

- **improve communication with medical providers;**
- **ensure injured workers are quickly provided quality, professional medical care; and**
- **provide programs for timely return to work.**

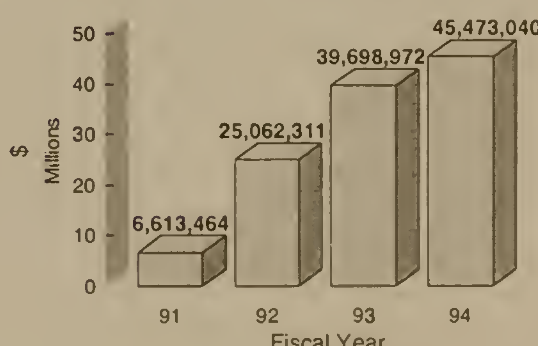
Medical Claims Costs



Improvements in quality medical care, together with carefully coordinated programs for early return-to-work and rehabilitation, will assist in curbing duration of indemnity claims.

In fiscal year 1993-94, the State Fund strengthened claim reserving to improve liability estimates. Programs to educate claim adjustors and to emphasize the importance of reserve adequacy resulted in visible

Indemnity Claims Costs



reserve strengthening. Future plans include implementing an automated reserving system to ensure accuracy and consistency in reserve development.

Another factor of stability includes stepped-up fraud investigations. Aggressive fraud investigations contributed to considerable present and future cost savings. The Fraud Investigation Unit had three major goals:

- **to reduce fraud;**
- **to save money; and**
- **to communicate the seriousness of fraud.**

National studies show that fraud is on the rise costing an estimated $17 billion. An estimated ten percent of premium dollars goes toward fraudulent claims. The State Fund's fraud savings in future claims costs totalled $1,365,852. In addition, $341,526 in court-ordered restitution and premium recoveries contributed to overall savings in fiscal year 1993-94.

The State Fund has set ambitious goals aimed at creating an organization that is no longer a liability to Montana but rather aids in economic growth of the state. Some of these goals include:

- **establishing an internal actuarial function;**
- **retaining desirable accounts;**
- **maximizing return on investment;**
- **pursuing aggressive fraud prosecutions;**
- **increasing surplus towards statutory requirement;**
- **managing the State Fund's administrative expenses within approved budget; and**
- **improving case reserves in relation to ultimate reserves.**

FRAUD DETECTION

County attorneys received 24 cases for fraud: Seven resulted in plea agreements and one conviction by jury. 16 cases remained open as of June 30, 1994.

Building a Stable and Efficient Organization

An organization must operate efficiently in order to be strong and stable. Efficient organizations provide the best service at the lowest cost. Efficient organizations provide a work environment that attracts and retains the best employees.

The State Fund addressed efficiency in all aspects of delivering workers' compensation insurance. Organizational changes were made to improve accountability and productivity. Through reorganization, three new departments were formed: Human Resources, Management Information Services, and Loss Control & Premium Audit.

A comprehensive Human Resources system will provide contemporary methods for classifying, paying, and appraising staff. This system will establish improved accountability through a competency- based, career development and pay for performance plan for our employees.

During fiscal year 1993-94, the State Fund made progress towards streamlining and automating in all areas. Departments worked together to facilitate and to support significant operational changes through automation. The Premium in Advance project was completed through cooperative efforts by all departments. Additionally, the State Fund Board of Directors allocated funding for a major automated claims management system incorporating document imaging. This project called the Benefits Information System is expected to be completed in late summer 1995.

The State Fund has made a firm commitment to provide quality service on time and at a reasonable cost. Future plans for improving operations in the coming year include an automated case reserve system, and a major upgrade of the automated medical processing system. In fiscal year 1994-95, the State Fund will embark on a reengineering study aimed at improving Underwriting, Policy Services, Loss Control, and Premium Audit services.

A closed claim study will

identify problem areas, trends, concerns, performance levels, and cost drivers. The information from this study will contribute to improving overall operations of the State Fund in the future. It will also serve as a baseline benchmark for future, similar studies to measure our improvements.

Fiscal year 1993-94 was a pivotal year for the Montana State Fund: a year of planning and positioning, and a year of working hard towards building a new foundation. Much remains to be accomplished, but the foundation for a strong organization is in place, emphasizing customer service and financial stability. Our staff is committed to these goals. The future of the State Fund is very bright!

Financial Statements
for year ending June 30, 1994

Balance Sheet

As of June 30, 1994

(Thousands of Dollars)

	1994		1993	
	New Fund	**Old Fund**	**New Fund**	**Old Fund**
ASSETS				
Cash in Treasury	$2,520	$1,404	$7,368	$294
Short-term Investment Pool	36,803	3,011	31,940	477
Premium Receivable	56,255		43,072	960
Accounts Receivable		987		
Allowance for Doubtful Accounts	(801)	(618)	(749)	(776)
Due from Other Funds	1,351	17,985	755	3,053
Deferred Bond Issue Charges		3,939		3,723
Interest Receivable	3,267		2,084	159
Long-term Notes & Loans Receivable			13,000	
Short-term Notes & Loans Receivable	515		393	12
Property Held in Trust	8,546		11,878	
Long-term Securities	310,236	10,914	182,574	10,818
Supplies Inventory	34		68	
Equipment	2,362		1,425	
Less Accumulated Depreciation	(724)		(498)	
Intangible Assets	19		11	
Other Assets	8		8	
TOTAL ASSETS	**$420,391**	**$37,622**	**$293,329**	**$18,720**
LIABILITIES AND FUND EQUITY				
Liabilities				
Accounts Payable	$105	$764	$80	$774
Due to Other Funds	374	1,792	808	757
Advance Deposits	15,808		21,045	
Compensated Absences	567	31	480	
Actuarially Est. Claims Liability	373,223	339,486	296,545	365,249
Unearned Premium	24,089			
Arbitrage Rebate Tax Payable		34		
Bonds/Notes Payable (Net)		166,907		149,376
TOTAL LIABILITIES	**$414,166**	**$509,014**	**$318,958**	**$516,156**
Fund Equity				
Contributed Capital	$12,001		$11,998	
Reserved for Debt Service		$14,169		$11,323
Unrestricted	(5,776)	(485,561)	(37,627)	(508,759)
TOTAL FUND EQUITY	**$6,225**	**($471,392)**	**($25,629)**	**($497,436)**
TOTAL LIABILITIES AND FUND EQUITY	$420,391	$37,622	$293,329	$18,720

The notes are an integral part of the financial statements.

Statement of Operations and Changes in Fund Equity

Year ending June 30, 1994

(Thousands of Dollars)

	1994 New Fund	1994 Old Fund	1993 New Fund	1993 Old Fund
INCOME				
Premium	$182,489	($5)	$170,556	$889
Less: Reinsurance Premium Paid	(318)		(289)	
Safety Incentive Refunds	(545)		(274)	
Interest Earnings on Investments	13,986	1,253	9,992	1,122
Interest Earnings on Loan	96		117	
Other Income	84	7	78	11
TOTAL INCOME	$195,792	$1,255	$180,180	$2,022
EXPENSES				
Claims Expenses:				
Compensation Benefits	$45,473	$20,459	$39,699	$35,699
Medical Benefits	30,087	7,915	28,602	10,668
Allocated Loss Adjustment Expenses	214	364		
Increase/Decrease in Actuarially Estimated Claims	76,678	(25,764)	84,550	(41,469)
Total Claims Expenses	152,452	2,974	152,851	4,898
Other Expenses:				
Operating Budget	9,090	1,691	7,097	2,481
Interest Expense		10,332		9,582
Other Expenses			1,101	804
Total Other Expenses	9,090	12,023	8,198	12,867
TOTAL EXPENSES	$161,542	$14,997	$161,049	$17,765
RESULTS OF OPERATIONS	$34,250	($13,742)	$19,131	($15,743)
Gain on Sale of Fixed Assets[a]	$3			
Operating Transfers In		$42,169		$18,274
Operating Transfers Out	(2,402)	(2,382)	($2,509)	(883)
Net Income (Loss)	31,851	26,045	16,622	1,648
June 30, 1993 Retained Earnings	(37,627)	(497,437)	(54,249)	(499,085)
Prior Period Adjustments				
RETAINED EARNINGS -- JUNE 30, 1994	($5,776)	($471,392)	($37,627)	($497,437)

a Gain on Sale of Fixed Assets is included in contributed capital.

The notes are an integral part of the financial statements.

Statement of Cash Flows

Year ending June 30, 1994

	1994 New Fund	1994 Old Fund
	(Thousands of Dollars)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts for Sales and Services	$188,824	$7
Payments to Suppliers for Goods and Services	(3,307)	(604)
Payments to Employees	(5,508)	(1,265)
Cash Payments for Claims	(75,574)	(28,414)
Collection of Notes Receivable		2
Other Operating Revenues	53	
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	**$104,488**	**($30,274)**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payment of Principal and Interest on Bonds and Notes		($33,305)
Proceeds from Issuance of Bonds and Notes		40,500
Payment of Bond Issuance Costs		(364)
Transfers to Other Government Agencies	($3,547)	(1,286)
Transfers from Other Government Agencies		27,167
Cash Payments for Loans	(28,266)	
Collections for Principal and Interest on Loans	43,173	
NET CASH PROVIDED BY (USED FOR) NONCAPITAL FINANCING ACTIVITIES	**$11,360**	**$32,712**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of Fixed Assets	($975)	
Proceeds from Sale of Fixed Assets	3	
NET CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES	**($972)**	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of Investments	($274,884)	($15,918)
Proceeds from Sales or Maturities of Investments	146,612	15,641
Interest and Dividends on Investments	13,411	1,481
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	**($114,861)**	**$1,204**
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$15	$3,642
CASH AND CASH EQUIVALENTS, JULY 1, 1993	**$39,308**	**$772**
CASH AND CASH EQUIVALENTS, JUNE 30, 1994	**$39,323**	**$4,414**

The notes are an integral part of the financial statements.

Statement of Cash Flows (cont.)

Year ending June 30, 1994

	(Thousands of Dollars) 1994 New Fund	1994 Old Fund
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating Income (Loss)	$34,250	($13,742)
ADJUSTMENTS TO RECONCILE OPERATING INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES:		
Depreciation	$257	
Amortization	9	
Interest Expense	1	$10,403
Interest on Investments	(14,081)	(1,253)
Change in Assets and Liabilities:		
Decrease (Increase) in Accounts Receivable	(16,293)	1
Decrease (Increase) in Due from Other Funds	1,059	
Decrease (Increase) in Inventories	34	
Decrease (Increase) in Other Assets	3,332	
Increase (Decrease) in Accounts Payable	26	
Increase (Decrease) in Due to Other Funds	277	16
Increase (Decrease) in Deferred Revenue	24,089	
Increase (Decrease) in Property Held in Trust	(5,237)	
Increase (Decrease) in Compensated Absences Payable	87	31
Increase (Decrease) in Arbitrage Tax Payable		34
Increase (Decrease) in Estimated Claims	76,678	(25,764)
NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	**$104,488**	**($30,274)**
SCHEDULE OF NONCASH TRANSACTIONS:		
Asset Disposals from Contributed Capital	(2)	
TOTAL NONCASH TRANSACTIONS	**($2)**	

The notes are an integral part of the financial statements.

Notes to Financial Statements

For the year ended June 30, 1994

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

The State Compensation Insurance Fund (State Fund) is a nonprofit, independent public corporation established to allow an option for employers in the State of Montana to insure their workers' compensation and occupational disease coverage under Title 39, chapter 71 of the Montana Codes Annotated (MCA). The State Fund is governed by a five member Board of Directors appointed by the Governor. The State Fund is attached to the State of Montana, Department of Administration for administrative purposes only. Because of the Governor's appointment of the Board members and the state's regulatory oversight function, the State Fund financial statements are presented as a component unit in the State of Montana combined annual financial report.

Chapter 4, Montana Special Legislative Session, May 1990, separated the liability of the state workers' compensation insurance fund based on whether the liability arises from claims for injuries resulting from accidents that occurred before or after July 1, 1990. The legislation establishes separate funding and accounts for claims occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund.

The New Fund functions as an autonomous insurance fund supported solely from its own revenues. All assets, debts, and obligations of the New Fund are separate and distinct from assets, debts, and obligations of the State of Montana. Upon dissolution of the New Fund, any monies not needed to liquidate the New Fund would be returned to its policyholders. The State Fund administers the claims remaining in the Old Fund for the state of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax. (See note #4, Old Fund.) No state general fund money is used for State Fund operations.

The State Fund records activity related to its workers' compensation insurance operations in the Enterprise Fund type. The Enterprise Funds of the State Fund are part of, but do not comprise, the entire Enterprise Fund of the State of Montana. These financial statements reflect the financial position and results of operations and cash flows of the State Fund, (New Fund and Old Fund), not the State of Montana.

Basis of Accounting

The State Fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations.

Under the accrual basis, the State Fund records revenues in the accounting period earned, if measurable; it records expenses in the period incurred, if measurable.

Cash and Short Term Investment Pool

Cash balances include demand deposits with the state treasury. Short Term Investment Pool (STIP) balances are highly liquid investments with maturities of three months or less. The market value of STIP amounts approximates cost.

Long Term Securities

The State Fund invests monies with the Montana Board of Investments, including STIP amounts. Securities are stated at cost, adjusted for amortization of any discount or premium. Premiums and discounts are amor-

tized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are not included in adjustments to retained earnings.

State Fund investments are classified in risk category 1 or risk category 2 under State of Montana standards. Risk category 1 includes investments that are insured or registered, held by the Board of Investments or its agent in the state's name. Investments in risk category 2 are uninsured or unregistered in which the securities are held by the counterpart's trust department or agent in the state's name. As of June 30, 1994, investments in the New Fund and the Old Fund include $81,505,623 and $10,913,990, respectively, in securities on loan. As of June 30, 1993, the New Fund and Old Fund investments include $60,723,778 and $10,818,212, respectively, in securities on loan. Securities on loan are classified as risk category 2. All other securities are in risk category 1. (See note 2.)

Montana's constitution does not allow the State Fund to invest in equity securities.

Receivables
Receivables in the New Fund include accrued premiums from the fourth quarter of fiscal year 1993-94 in the amount of $43 million. The balance of the New Fund premium receivable includes amounts due for policies effective July 1, 1994, billed in advance.

Accounts receivables in the Old Fund include interest receivable and amounts due from past premiums in dispute or in collection. Estimated uncollectible receivables are reported as an allowance for doubtful accounts.

Fixed assets
Equipment is valued at actual or estimated historical cost. Depreciation expense is computed on a straight-line basis for equipment over a period of 5 to 10 years. All fixed assets are recorded in the New Fund. Because the State Fund administers the Old Fund, the Old Fund does not carry fixed assets.

Advance Deposits
Advance deposits are required policyholder deposits which secure payment of premiums.

Premiums
Premium rates are approved by the State Fund Board of Directors. Policies are effective July 1 until June 30, of each year. Revenue from premiums is recognized over the term of the year.

Effective July 1, 1994, policyholders are contractually obligated to advance certain premiums to the State Fund in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is cancelled and all earned premiums have been credited by the State Fund. Unearned premiums reflect amounts in advance that are received or billed but not yet earned for policies effective July 1, 1994.

Contributed Capital
Contributed capital accounts for assets transferred at the inception of the New Fund to provide the initial capitalization of the New Fund as authorized by state law and equipment transferred from the Department of Labor and Industry upon transfer of premium audit functions to the State Fund.

Fund Equity
Fund Equity consists of contributed capital and the net excess or deficit of assets over liabilities.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State Fund insurance operations are classified in the Enterprise Fund type.

The Enterprise Fund type is used to account for operations (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

2. INVESTMENTS

The amortized cost and market value of the New Fund fixed maturity securities June 30, 1994, and June 30, 1993, are as follows:

June 30, 1994	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
US Treasury Securities	$86,528,114	$33,611	($3,514,325)	$83,047,400
US Government Agencies and US Government Guaranteed Securities	$54,747,259	$78,783	($2,132,981)	$52,693,061
Corporate Securities	$160,934,910	$92,105	($4,233,955)	$156,793,060
Other Securities	$8,026,264	$0	($512,133)	$7,514,131
STIP	$36,802,900	$0	$0	$36,802,900
Totals	347,039,447	$204,499	($10,393,394)	$336,850,552

June 30, 1993	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
US Treasury Securities	$54,697,772	$681,986	$0	$55,379,758
US Government Agencies and US Government Guaranteed Securities	$13,628,642	$13,237	($28,365)	$13,613,514
Corporate Securities	$108,232,241	$1,255,670	($30,005)	$109,457,906
Other Securities	$6,016,148	$77,432	$0	$6,093,580
Loan to Old Fund	$13,000,000	$0	$0	$13,000,000
STIP	$31,940,300	$0	$0	$31,940,300
Totals	$227,515,103	$2,028,325	($58,370)	$229,485,058

The amortized cost and estimated market value of fixed maturity securities as of June 30, 1994, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
Due one year or less	$ 36,802,900	$36,802,899
Due after one year through five years	165,883,044	162,104,274
Due after five years through ten years	78,304,120	73,757,069
Due after ten years	66,049,383	64,186,310
Totals	$347,039,447	$336,850,552

During fiscal year 1993-94, gross gains realized from sales of fixed maturity securities were $949,787 and gross losses realized were $786,519.

Long term securities in the Old Fund of $10,913,990 are required debt service reserve deposits related to long term workers' compensation program bonds. The market value of these securities is $10,416,515. Old Fund STIP balance at June 30, 1994, include $2.8 million required debt service reserve deposits for variable rate payroll tax bonds. (See note 5.)

3. REINSURANCE

The State Fund cedes reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts which protect against losses over stipulated amounts. The State Fund retains the first $1 million of each loss and $1.6 million in aggregate retention, while reinsurers are liable for losses in excess of $1 million up to a limit of $20 million on occurrences involving multiple claimants. Individual per person coverage is provided up to $2 million per claimant. In the event reinsurers are unable to meet their obligations, the State Fund would remain liable for all losses as the reinsurance agreements do not discharge the State Fund from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $318,356 and $289,234 in fiscal years 1993-94 and 1992-93, respectively. Reinsurance had no effect on fiscal year 1993-94 and 1992-93 losses and loss adjustment expense.

4. RISK MANAGEMENT-PUBLIC ENTITY RISK POOLS

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socioeconomic factors.

New Fund—Liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana and workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At fiscal year-end 1993-94, approximately 26,100 employers were insured with the New Fund. Anticipated investment income is considered for computing a premium deficiency and employers must pay premiums to the State Fund within specified timeframes.

Tillinghast, a Towers Perrin company for the New Fund as of June 30, 1994, prepared an actuarial study and estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 1994, $509,019,962 of unpaid claims and claim adjustment expenses are presented at their net present value of $373,223,095. These claims are discounted at an annual rate of 5.75%. As of June 30, 1993, $404,705,624 of unpaid claims and claim adjustment expenses are presented at their net present value of $296,545,100. These claims as of June 30,1993, are discounted at an annual rate of 6 percent. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of the New Fund is terminated.

State law requires the New Fund to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires the State Fund to establish a surplus balance of 25% of annual premium revenue by July 1, 2003.

Old Fund—The liability and payment of workers' compensation claims for incidents occurring before July 1, 1990, are reported in the Old Fund. There is no premium income; however, funding for claims payments is provided by old fund liability taxes (OFLT) imposed on employers payroll (0.5%), employees wages (0.2%), and sole proprietors and subchapter S shareholders distributive income (0.1%). The OFLT for sole proprietors and shareholders increased to 0.2% beginning January 1, 1994. The OFLT is to provide funding for Old Fund claims expenses and Old Fund bond payments. (See Note 5.) An actuarial study prepared by Tillinghast, a Towers Perrin company for the Old Fund as of June 30, 1994, was used to estimate liabilities and the ultimate cost of settling claims that have been reported but not settled and claims that have been incurred but not reported. As of June 30, 1994, $339,485,647 of unpaid claims and claim adjustment expenses are presented at face value. As of June 30, 1993, $365,249,186 of unpaid claims and claim adjustment expenses are presented at face value. Total Old Fund deficit as of June 30, 1994 is $471,39,590. This fund does not discount estimated claims liability.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes (in thousands) in the aggregate liabilities for the New Fund and the Old Fund for the past two years. The information presented has not been discounted.

	New Fund		Old Fund	
	1994	1993	1994	1993
Unpaid claims and claim adjustment expenses at beginning of year	$404,706	$291,402	$365,249	$406,719
Incurred claims and claim adjustment expenses:				
Provision for insured events of the current year	184,039	170,792		
Increases in provision for insured events of prior years	(3,952)	14,422	2,975	7,500
Total incurred claims and claim adjustment expenses	180,087	185,214	2,975	7,500
Payments:				
Claims and claim adjustment expenses attributable to insured	(18,693)	(19,087)		
Claims and claim adjustment expenses attributable to insured events of prior years	(57,080)	(52,823)	(28,739)	(48,970)
Total Payment	**(75,773)**	**(71,910)**	**(28,739)**	**(48,970)**
Total unpaid claims and claim adjustment expenses at end of the year	**$509,020**	**$404,706**	**$339,485**	**$365,249**

Risk Management Trend Information

The following table illustrates how the earned revenues of the New Fund plus investment income compare to related costs of loss and other expenses assumed by the State Fund for fiscal years 1991 through 1994. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and reestimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

	New Fund			
	1991	1992	1993	1994
1. Net earned required contribution and investment revenues	$105,542	$132,423	$179,359	$184,412
2. Unallocated expenses including overhead	6,048	8,232	9,325	9,090
3. Estimated incurred claims and expenses, end of policy year	137,237	183,425	186,480	199,890
4. Paid (cumulative) as of:				
End of policy year	17,618	20,244	18,347	18,693
One year later	44,335	50,576	46,343	
Two years later	64,079	68,837		
Three years later	74,901			
5. Reestimated incurred claims and expense:				
End of policy year	137,237	183,425	186,480	199,890
One year later	166,980	184,968	184,030	
Two years later	160,272	175,218		
Three years later	151,554			
6. Increase (decrease) in estimated incurred claims and expense from end of policy year	14,317	(8,207)	(2,450)	

5. PAYROLL TAX BONDS (WORKERS' COMPENSATION PROGRAM)

The Board of Investments of the State of Montana issued $142,095,000 of bonds in July 1991 for the purpose of funding the state's liability and costs in administering and paying claims for injuries resulting from accidents, prior to July 1, 1990, that are subject to the Montana Workers' Compensation Act and the Occupational Disease Act of Montana. The bonds bear interest at rates from 4.9 to 6.875 percent and are limited obligations of the State of Montana payable solely from and secured by certain Old Fund liability tax revenues collected by the Department of Revenue of the State of Montana. Amounts of bond debt outstanding as of June 30, 1994 are shown below (in thousands).

Bonds Outstanding June 30, 1994	Discount	Net Bond Debt June 30,1994
$136,265	$1,858	$134,407

Debt service requirements for principal and interest are as follows (in thousands):

Fiscal Year	Debt Service Payments
1994-95	11,318
1995-96	11,321
1996-97	11,318
1997-98	11,318
1998-99	11,318
1999+	237,722
Totals	**$294,315**

On October 27, 1993, the Board of Investments issued $32,500,000 in Variable Rate Payroll Tax Bonds (Workers' Compensation Program Series 1993) to pay the costs associated with claims incurred on or before June 30, 1990. The Series 1993 Bonds are limited obligations of the State of Montana, payable solely from and secured by certain Old Fund liability tax revenues. Bond proceeds were used to repay $21,321,007 million in loan principal and interest to the New Fund and the remaining proceeds after issuance costs of $7,962,247 were pledged to meet Old Fund claims costs. The variable rate bonds pay interest determined on a weekly period established by a remarketing agent. The variable rate bonds are subject to redemption at the discretion of the Board of Investments during the period variable rates are applied on the bonds. The bonds are payable June 1, 2020, unless terminated at an earlier date upon certain occurrences. In fiscal year 1993-94, $601,827 in interest payments and fees were paid on the variable rate bonds.

6. ADMINISTRATIVE COST ALLOCATION

State law requires the State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to $3 million. The State Fund allocated $2.9 million and $2.3 million in administration costs to the Old Fund in fiscal years 1993-94 and 1992-93, respectively.

7. TRANSFERS

Operating transfers out of the New Fund include transfers to the Department of Labor and Industry for regulatory administrative assessments charged to the State Fund.

Operating transfers recorded in the Old Fund include $41 million in fiscal year 1993-94 and $18 million in fiscal year 1992-93 of old fund liability tax (OFLT) revenue collected by the State of Montana Department of Revenue. (See note 4.) Operating transfers out of the Old Fund include administrative costs of $1.3 million.

8. COMPENSATED ABSENCES

Employees at the State Fund accumulate both annual and sick leave. The State Fund pays employees for 100 percent of unused annual leave and 25 percent of unused sick leave upon termination. The fund pays 100 percent of unused compensatory leave credits upon termination to nonexempt employees. The State Fund absorbs expenditures for termination pay in its annual operational costs. The State Fund had a total leave liability of $598,092 and $480,028 at June 30, 1994, and June 30, 1993, respectively.

9. PENSION PLAN

The State Fund and its employees contribute to the Public Employees Retirement System (PERS), a cost sharing, multiple employer, defined benefit pension plan. Established in 1945 and governed by Title 19, Chapter 3, MCA, PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. A reduced retirement benefit may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average monthly salary. Vesting occurs once membership service totals 5 years. State Fund and its employees each were required to contribute 6.7 percent and 6.55 percent of annual compensation in fiscal years 1993-94 and 1992-93, respectively.

As of June 30, 1994, there were 249.75 State Fund full-time equivalents (FTE) covered by PERS. State Fund covered payroll was $5,219,689 and PERS contributions were $434,174 in fiscal year 1993-94.

As of June 30, 1993, there were 221.5 State Fund full-time equivalents (FTE) covered by PERS. State Fund covered payroll was $4,829,865 and PERS contributions were $311,990 in fiscal year 1992-93.

Actuarial valuations are performed at PERS every two years. The latest valuation was performed as of July 1, 1994. In calculating the pension benefit obligation, the actuary assumed a return on investments of 8 percent, salary inflation increases of 6.25 percent and no change in post retirement benefits.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the system's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due and make comparisons among employers. The State Fund is unable to determine the actuarial present value of credited projected benefits and net assets available for benefits since the information is available only on a total state basis, not agency basis.

The pension benefit obligation as of June 30, 1994, for PERS as a whole was $1,475,985,705. The system's net assets available for benefits at cost on June 30, 1994, were $1,202,063,252 leaving an overall unfunded pension benefit obligation of $273,922,453. The State Fund's 1994 contribution represented approximately 1.1 percent of total June 30, 1994, contributions required of all participating entities. The State Fund is not responsible for any state system unfunded liability.

Ten-year historical trend information showing the PERS progress in accumulating sufficient assets to pay benefits when due is presented in the system's June 30, 1994, annual financial report.

10. BUILDING

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. State Fund expenses annual payments on the building in its operating budget. As of July 1, 1990, the State Fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the State Fund will pay all costs associated with the building, including utilities, debt service, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. SUBSEQUENT EVENT

A class action was filed before the Workers' Compensation Court in *Murer, et al. vs. Montana State Compensation Mutual Insurance Fund, et al.,* which attempts to have the Court rule that a freeze on workers' compensation benefits in place in fiscal years 1988 through 1991 should no longer apply once the date of the freeze expired. The State Fund's position is that the law in existence at the time of the injury applies for the life of the claim. The case was rejected by the Workers' Compensation Court as a class action and that decision was affirmed by the Montana Supreme Court. The case was then set before the Workers' Compensation Court and included only named claimants and insurers. Though not a class action, an adverse decision will have the same impact. The Workers' Compensation Court rejected the case and it was appealed to the Montana Supreme Court. On November 21, 1994, the Montana Supreme Court reversed the decision of the Workers' Compensation Court. The estimated amount of loss has been previously estimated as lesser amounts up to $11,000,000. Management believes the ruling will have a material impact on the New Fund and the Old Fund; however, this case is subject to a pending rehearing request before the Montana Supreme Court and then a hearing on remand before the Workers' Compensation Court to rule on issues so that claims eligible for recovery can be fully determined. As a result, an estimate of actual loss incurred cannot be determined until the State Fund receives final decisions on this matter.

Actuarial Letter

Tillinghast
A Towers Perrin Company

One Tabor Center
1200 Seventeenth Street, Suite 1200
Denver, CO 80202-5812
303 628-4000
Fax: 303 628-4090

November 15,1994

To Members of the State Fund Board of Directors:

Tillinghast, a Towers Perrin Company, was engaged by the Montana State Compensation Insurance Fund (the Fund) to estimate the unpaid loss and loss adjustment expenses as of 6/30/94 for the Fund's workers compensation exposures. We examined both the New Fund and the Old Fund, using data as of 6/30/94. As of 6/30/94, our estimated discounted liability for the New Fund is $373.2 million (based on a 5.75% interest rate selected by the Fund). Thus, assets exceed the discounted liabilities by $6.2 million. As of 6/30/92, the Fund posted a deficit; the difference between discounted liabilities (based on a 7% interest rate) and the Fund's assets was $42.3 million. As of 6/30/93, the Fund also posted a deficit; the difference between discounted liabilities and the Fund's assets was $25.6 million.

The elimination of the deficit as of 6/30/94 results from a combination of improving loss experience and the rate level increases implemented by the Fund. Our analysis and results, along with the discussions of important reliances and limitations, are documented in rate, reserve, and other reports to Fund management. These reports discuss the inherent uncertainty associated with estimating the Fund's liability and evaluating the adequacy of rates. Note that the estimates assume that sufficient assets are held to generate the appropriate investment income at the selected interest rate.

We continue to recommend that the Fund set a long-term goal of achieving and maintaining surplus based partly on industry standards. This means rate changes should not only reflect cost estimates for the prospective year, but also include a provision for building surplus.

A key phrase in the foregoing recommendation is "long-term". Efforts to build surplus and reach the surplus goal should be viewed as multi-year. We believe that the long-term approach is preferable to the volatility of large year-to-year rate changes. This recommendation rests on two important assumptions. First, we have assumed that the Fund will have sufficient cash flow to fund claims obligations. Second, we have assumed that the Fund will be an ongoing concern until the claims obligations are fulfilled.

It is our opinion that immediate aggressive rate level action to quickly reach the Fund's surplus goal is not the best way to attain the goal of the Fund being self-supporting and not having unnecessary surplus. Instead, the Fund should have a long-term goal of building the targeted surplus. Our October, 1994 reserve report indicates that the current year is priced so that it is expected to make a contribution to surplus, as well as providing, on a discounted basis, for claims occurring between 7/1/94 and 6/30/95.

By following a plan to build reasonable surplus, and by adjusting rates to reflect emerging loss experience, the Fund can expect to steadily move toward achieving its surplus goal.

Sincerely,

Martin A. Lewis, FCAS, MAAA
MAL:elb

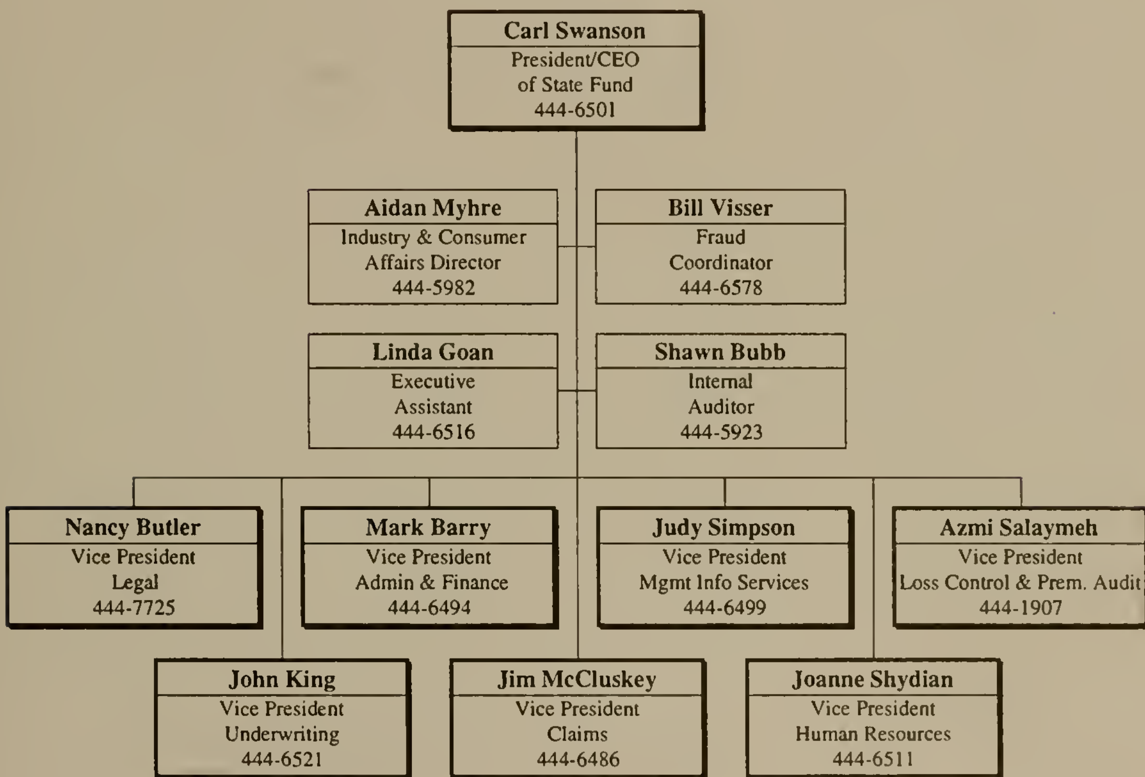
Report of Management
Statement of Financial Reporting Responsibility

The management of the State Compensation Insurance Fund is responsible for the financial statements and all other information presented in this annual report. The financial statements have been prepared in conformity with generally accepted accounting principles and include amounts based on the best estimates and judgments of management.

The State Fund maintains a system of internal control. The system of internal control is designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. The system of internal control encompasses the organizational structure, selection and training of personnel, communication, and enforcement of policies and procedures. The system of internal control is continually reviewed and evaluated by management.

The balance sheet and related statements of operations and changes in fund balance, and cash flow at and for the period ending June 30, 1994, presented in this report have not been compiled, reviewed, or audited by independent auditors. Comparable audited financial statements of the State Fund for the fiscal years ended June 30, 1993 and 1994, are available from the State of Montana, Office of the Legislative Auditor.

Organizational Structure



Board of Directors

Rick Hill, Chairman
Helena, Montana
Term: 1993-1997

Robbie Holman
Kalispell, Montana
Term: 1991-1995

Les Hirsch
Miles City, Montana
Term: 1991-1995

Sandra Reiter
Billings, Montana
Term: 1993-1997

Jim Brouelette
Missoula, Montana
Term: 1993-1997

Carl Swanson, President/CEO
Helena, Montana
Term: Ex-Officier Member

STATE COMPENSATION INSURANCE FUND

PO Box 4759
5 South Last Chance Gulch
Helena, Montana 59601-4132
(406) 444-6500

613 South 3rd Street West
Suite 101
Missoula, Montana 59801
(406) 543-1296

Services Provided by the Missoula Office

Assisting and educating policyholders on applications, payroll reports, premium payments, billing complications, independent contractor issues, safety concerns, fraud detection, and all aspects of workers' compensation law.

Assisting claimants with claim filing, complications with medical providers and employers, workers' compensation law and procedures. Also acts as a liaison for internal claims adjustors and accepts claim forms and supporting documentation.

Advising medical providers about claims filing, billing procedures, and issues pertaining to workers' compensation law. Also provides forms and receives medical reports.

1,500 copies of this public document were published at an estimated cost of $1.12 per copy, for a total cost of $1,680.00, which includes $1,680.00 for printing and $.00 for distribution.